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San Diego Public Facilities Financing Authority, California; Water/Sewer

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Table Of Contents

Rationale

Outlook

System

Regulatory Issues And Capital Improvement Plan

Rates

Audit Restatements And Internal Controls

Service Economy

San Diego Public Facilities Financing Authority, California; Water/Sewer

Credit Profile		
San Diego Pub Facs Fincg Auth, California		
San Diego, California		
San Diego Pub Fac Fing Auth (San Diego) Swr		
<i>Unenhanced Rating</i>	A+(SPUR)/Stable	Rating Assigned
San Diego Pub Facs Fincg Auth, California		
San Diego, California		
San Diego Pub Fac Fing Auth (San Diego) Swr		
<i>Unenhanced Rating</i>	A+(SPUR)/Stable	Rating Assigned
Many issues are enhanced by bond insurance.		

Rationale

Standard & Poor's Ratings Services assigned its 'A+' rating, and stable outlook, to the San Diego Public Facilities Financing Authority, Calif.'s sewer revenue bonds, issued for San Diego.

The rating reflects:

- Good historical and projected debt service coverage (DSC);
- A strong liquidity position supported by targeted cash reserve policies;
- Council-approved system rate increases through May 1, 2010; and
- A regional and municipal system serving a broad and diverse service area economy and customer base.

These strengths are offset by the wastewater system's:

- Ongoing sewage treatment regulatory challenges, related primarily to a consent decree and secondary treatment requirements at the Metropolitan Sewerage System's Point Loma Plant, which have the potential to cause significant increases in the capital improvement plan (CIP);
- Higher-than-average rates when compared with regional systems across the country; and
- Legal provisions that allow net system revenue calculations to include transfers from the rate stabilization fund.

A senior-lien pledge of installment payments paid from net revenues of the wastewater system secures the bonds.

The wastewater system consists of both a sewage collection system for the city of San Diego (Municipal Wastewater Collection System) and a regional system (Metropolitan Sewerage System) that provides a transportation, treatment, and disposal system for 2.3 million customers in the city of San Diego and 15 other cities and districts in a 450-square-mile service area. The municipal system provides service to 274,000 primarily residential (94%) and commercial and industrial (6%) accounts. The leading 10 customers of the municipal system represent 8.8% of total service charge revenues in fiscal 2007 and include the U.S. Navy, chemical manufacturer CP Kelco, the University of California-San Diego, and the city itself. Residential customers represent 60% of total system revenues, while

commercial customers represent 19% of revenues; treatment plant services for other cities and districts make up the remaining 19% of system revenues.

The wastewater system has roughly \$1.2 billion of outstanding bonds and loans secured by the system's net revenues, including senior revenue bonds, subordinate state revolving fund (SRF) loans, and roughly \$220 million of short-term notes issued in 2007 and secured by a subordinate lien of the net system revenues. The legal provisions include a 1.2x annual DSC rate covenant, which includes onetime transfers in or out of the rate stabilization fund in its net system revenue calculation. Legal provisions also include an additional bonds test that requires 1.2x maximum annual debt service (MADS) coverage by net system revenues in 12 out of the past 18 months and estimated revenues in the next 12 months.

Senior-lien annual DSC was 1.5x in fiscal 2006; system officials estimate net system revenues to provide 1.8x coverage in fiscal 2007, based on unaudited results. Excluding capacity charges, estimated fiscal 2007 senior DSC is 1.6x. When including existing subordinate-lien SRF loans and notes, the coverage is a still-good 1.5x in fiscal 2007, excluding capacity charges. System officials project net revenues between fiscals 2008 and 2009 to cover existing senior-lien debt service by 1.5x and 1.8x, respectively.

Wastewater system liquidity remained strong, with audited unrestricted cash at \$177 million, or 324 days' cash on hand, at fiscal year-end 2006. Officials have identified reserve policies to maintain minimum amounts of cash reserves for operations, rate stabilization, and contingencies, including a targeted 50- to 70-day operating reserve to be used in the event of an emergency, a rate stabilization fund to be maintained at 20% of system revenues, and a \$5 million reserve for unexpected capital needs. The system also maintains restricted cash reserves for debt service requirements. Management estimates that the wastewater fund had a total of \$49 million (or 96 days' combined cash) in the targeted reserves, including \$13.3 million available in its rate stabilization fund and another roughly \$35 million available in its operating reserve, capital reserve, and unallocated reserve in fiscal 2007.

The system's large \$645 million CIP through 2011 is driven by regulatory concerns and an aging infrastructure. The system is currently operating under a consent decree by the Environmental Protection Agency (EPA) to reduce sewer spills, which drives 75% of the system's current CIP in the next few years. The council pre-approved wastewater rate increases of between 7.00% and 8.75% for fiscals 2008 through 2011, as recommended in a 2006 rate study to cover these capital needs of the system. Since 1995, the system's Point Loma Wastewater Treatment Plant has operated under two five-year waivers of secondary treatment standards for discharge of its treated wastewater as specified in the Federal Clean Water Act of 1972. The system has applied for a new five-year waiver at its Point Loma plant, which, if approved, would renew a current waiver that expires in June 2008. Should the system fail to receive the waiver, the system's capital needs could increase significantly, as potential capital costs necessary to upgrade the current plant to meet secondary treatment standards are estimated to be as high as \$1.5 billion.

Outlook

The stable outlook reflects the expectation that pre-approved rate increases by the city council and cash reserve policies should help to maintain good projected debt service ratios and good system liquidity in the next several years, despite the city's implementation of a large CIP associated with regulatory requirements. The outlook also reflects the expectation that the system will receive the five-year modified permit from the EPA for its Point Loma

plant, as it has twice before, to avoid significant near-term costs to retrofit the plant to meet secondary treatment requirements. Should the system fail to receive the waiver or fail to make sufficient rate increases to maintain adequate DSC ratios, the rating could be pressured.

System

The metropolitan system provides wholesale treatment services -- including some sewage transportation, treatment, and disposal operations -- to 15 participating agencies under a regional wastewater disposal agreement that became effective May 18, 1998, and expires on Dec 31, 2050. The participating agencies pay the system proportionate payments based on flow and strength for all facilities. The wastewater treatment facilities of the metropolitan system primarily consist of four wastewater treatment plants, including two water reclamation plants. The Point Loma Wastewater Treatment Plant, the principal treatment facility, is an advanced primary treatment plant with a permitted treatment capacity of 240 million gallons per day (mgd), compared with a peak flow of 231 mgd in fiscal 2007.

Regulatory Issues And Capital Improvement Plan

The Point Loma Wastewater Treatment Plant is currently an advanced primary treatment plant that removes about 80% of suspended solids from the wastewater it discharges into the ocean. In 2002, the EPA granted the system a renewal of a previous five-year National Pollutant Discharge Elimination System modified permit (waiver) to exempt it from the more stringent secondary treatment requirement of the Clean Water Act; the system has submitted another waiver renewal application and is currently waiting a response from the EPA. Should the system fail to receive approval of an additional waiver, its CIP could substantially increase by up to \$1.5 billion due to the cost associated with converting the system to meet secondary treatment requirements.

In addition, the system is currently under a consent decree that was finalized in October 2007 and requires the system to replace 250 miles of sewer pipeline by 2013 and rehabilitate its wastewater facilities to remediate system sewer spills; in March 2005, the city also settled a state lawsuit and paid a \$1.2 million penalty due to system sewer spills. The system is currently on track to meet the consent decree requirements, but will need to issue debt under its CIP to continue to make pipeline repairs. Officials expect to fund 80% of the system's current CIP with debt.

Rates

In 2007, the sewer system settled a lawsuit by agreeing to reimburse residential customers a cumulative \$40 million for previous overcharges of their sewer bills (Shames Settlement). On Nov. 1, 2007, the system increased rates by 3% for nonresidential customers to equalize the rate structure per the Shames Settlement. The city council pre-approved wastewater rate increases for four consecutive years between 2007 and 2010 to address the wastewater system's CIP. These scheduled rate increases do not account for any potential secondary treatment costs or increases related to the Shames Settlement. Current residential sewer rates are somewhat above average, at \$42.50 for a single-family home using 7,500 gallons per month, after accounting for a \$3.25-per-month adjustment on residential bills per the Shames Settlement. Together with the sewer rates, overall rates are somewhat above average for a regional system, at roughly \$75 per 7,500 gallons per month, but are still a manageable 2% of the city's annual median household income.

Audit Restatements And Internal Controls

The fiscal 2003 audit included 22 restatements within the fiscal 2002 financial statements for the sewer utility fund, which resulted in a net \$61 million increase of sewer utility fund assets. The largest restatements in the sewer utility fund involved the inaccurate recording of depreciation and capitalization of capital assets. The previous fiscal 2002 audit also incorrectly recorded interfund transfers as working capital advances, resulting in a gross \$19 million decrease in the utility fund's net assets.

After the Securities and Exchange Commission and U.S. Attorney began investigations of the city's finances and disclosure practices in 2004, the city hired Kroll Inc., a risk-management consulting company, to conduct an independent investigation of the city's retirement system, sewer rates, and financial controls, and make recommendations for reform. Kroll released its report in 2006 detailing 121 recommendations to strengthen the city's internal controls. The city has made progress toward improving internal controls and disclosure processes, implementing 92 of the 121 recommendations. However, the city acknowledges it still has to continue to bolster internal controls, particularly in the areas of financial reporting, information technology, and internal controls. City management expects the full implementation of new financial enterprise resource planning (ERP) software in January 2010 to help resolve internal control weaknesses and aid in the timely release of future financial reports. City officials expect to release the fiscal 2007 audited financial statements in the next few months and the fiscal 2008 audit by the end of the year.

Service Economy

San Diego's population, estimated at 1.32 million in fiscal 2007, has grown an average of roughly 1% per year since the 2000 U.S. Census. The economy consists of a mix of various high-tech clusters, including biotech and telecommunications, combined with a reliance on tourism and the military and defense industries. The city's economic base is also anchored by higher education and major scientific research institutions, including the University of California, San Diego, San Diego State University, Scripps Research Institute, the Salk Institute for Biological Studies, and the San Diego Supercomputer Center. On a per capita basis, market values are extremely strong, at roughly \$134,000, reflecting strong city wealth levels. Median household effective buying income is also strong, at 111% of the national average in 2007.

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